August 2010

AK Position Paper

Consultation Paper of the Commission:

Possible further changes to the Capital Requirements Directive (CRD IV)

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About us

The Federal Chamber of Labour is by law representing the interests of about 3.2 million employees and consumers in Austria. It acts for the interests of its members in fields of social, educational, economical and consumer issues both, on the national and on the EU-level in Brussels. Furthermore the Austrian Federal Chamber of Labour is a part of the Austrian social partnership.

The AK EUROPA office in Brussels was established in 1991 to bring forward the interests of all its members directly vis-à-vis the European Institutions.

Organisation and Tasks of the Austrian Federal Chamber of Labour

The Austrian Federal Chamber of Labour is the umbrella organisation of the nine regional Chambers of Labour in Austria, which have together the statutory mandate to represent the interests of their members.

The Chambers of Labour provide their members a broad range of services, including for instance advice on matters of labour law, consumer rights, social insurance and educational matters.

More than three quarters of the 2 million member-consultations carried out each year concern labour, social insurance and insolvency law. Furthermore the Austrian Federal Chamber of Labour makes use of its vested right to state its opinion in the legislation process of the European Union and in Austria in order to shape the interests of the employees and consumers towards the legislator.

All Austrian employees are subject to compulsory membership. The member fee is determined by law and is amounting to 0.5% of the members' gross wages or salaries (up to the social security payroll tax cap maximum). 560.000 – amongst others unemployed, persons on maternity (paternity) leave, community and military service – of the 3.2 million members are exempt from subscription payment, but are entitled to all services provided by the Austrian Federal Chambers of Labour.

Herbert Tumpel
President

Werner Muhm
Director

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Executive Summary

The stability of the financial markets as the basis for stable economic growth is of the highest interest for employees.

The serious financial and economic crisis has shown that the current regulatory system that makes strongly model-based assumptions, which in turn are based on historic data, in connection with the valuation rules of true and fair value accounting, may result in undesired procyclic effects, apart from not having been able to prevent the crisis. Other significant contributors to the development of the systemic risk are also those elements of the financial system, which are not or only insufficiently covered by the regulation. To some extent, this was carried out via a shadow bank system by off-balance transactions and special investment vehicles, significant numbers of which are located in non-cooperative or insufficiently cooperative jurisdictions with inadequate regulatory standards. This resulted in an excessively high leverage, which could only be maintained as long as the illusion of always-available liquidity could be upheld. After the outbreak of the crisis, only massive interventions of central banks and governments, which used vast amounts of tax money, were able to prevent the situation from worsening.

At the centre of the crisis was in particular the "originate and distribute model" of lending, hence the certification and recertification of loans. This commission-oriented business in connection with false ratings leads to absurd risk incentives. The argument that this model would even have a risk-reducing effect through diversification options, has collapsed. Certification and disposal have led to the fact that the risk was no longer assessed in a way a prudent businessman would do it.

These elements of the crisis have shown that the regulation of the banking functions and not the reference to institutions should be at the centre of reregulation. It has also become evident that many assumptions were too optimistic and that neither the quality nor the quantity of the capital resources of the financial institutions was suitable to absorb the risks taken.

The stability of the financial markets as the basis for stable economic growth is of the highest interest in particular for employees. Financial market crises massively burden employees in form of serious turbulences at the labour market and with losses of pension provisions. In addition, employees have to bear the brunt of the crisis by paying higher taxes and coping with serious cuts, for example in the health or education sector. In particular, from the perspective of employees, it is important to make sure that the banks fulfil their financing function. The adequate access to loans for companies and private households is an important requirement for the smooth functioning of the economy and with that for the labour market.

The AK welcomes the initiative to introduce liquidity standards, to improve capital resources, to introduce anti-cyclic buffers, to create more transparency in the derivative trade as well as the harmonisation of rules in the Internal Market.

The AK therefore welcomes the initiative to introduce liquidity standards, to improve capital resources, to introduce anti-cyclic buffers, central counterparties and to create more transparency in the derivative trade, the discussion of the issue of systemic important institutions and the harmonisation of rules in the Internal Market.

As already mentioned above, the approaches should manage with as few assumptions as possible, which are inevitably based on historic data and the regulation should choose a functional approach. Any institution, which assumes banking functions, should, with regard to these functions, be subjected to the same rules as a financial institute.

Apart from these microprudential approaches, it will also be important to discuss the macroeconomic imbalances, which have also contributed to the crisis. These include imbalances both between individual economies - lack of domestic demand in surplus countries and debt-financed consumption in deficit countries - as well as within those economies, which have only made these structural imbalances between the countries possible. These include above all falling wages and an increasing imbalance of personal income and wealth distribution. Surplus countries compensated the falling domestic demand by exports, deficit countries by borrowing. Only a symmetric approach between the countries and a reduction of the unbalanced functional and personal income distribution can bring a more balanced, sustainable and therefore more crisis-resistant growth from this side.

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The AK position in detail

Section I - Liquidity standards for financial institutions and investment companies

Question 1 and 2:

On the stress scenario:

As also emphasised in the Larosière report, in particular misjudgements by rating agencies led to false risk and price signals. The de Larosière Group therefore recommended to reduce the significance of ratings in legislative references. From our point of view, it would be desirable to think about alternative factors under Item 5 (a). However, it seems to be important to include both company-specific and systemic shocks into the shock scenarios.

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On Nettability in Appendix 1:

Stock ("buffer") of highly liquid assets:

The current crisis has shown that although depth and width of the market as well as low volatility and low market concentration represent important criteria, they can quickly change in crisis situations. Apart from these market criteria, the lending ability of Central banks is therefore a central criterion, which from the point of view of the AK should definitely be included, which would vice versa, with regard to the instruments provide more flexibility (in a systemic crisis, however, papers, issued by MFI, would themselves be exposed to a high liquidity risk). In the current crisis, the central banks have proven that they are flexible and close enough to the market to take stress factors out of it. Apart from the stated advantages of higher robustness by LCR and NSFR, the AK also sees an advantage in the fact that the MFI sector in case of creating bank money would once again be stronger linked to the central banks, which could increase the effectiveness of monetary control. Based on stability considerations, the criterion of lending ability of instruments with central banks are important and should be supported.

Apart from that, it is highly significant to include possible cash outflows from off balance sheet transactions (and SIV, Conduits,...) as these might trigger considerable liquidity risks.

Vice versa, it is right to strongly underweight deposits protected by deposit insurance systems, as one of the main purposes of deposit protection is to avoid a bank collapse.

Based on the underweighting of the deposits covered by the deposit insurance systems, the conditions in this sector should be less affected than other elements. Attention must also be paid to the fact that the costs of maintaining liquid assets is less profitable, because less risky tradable assets in form of lost income, are also confront-

ed with savings based on a low equity deposit obligation of these papers, which per se results in the reduction of the net burden due to higher liquidity requirements.

Question 3:

The inclusion of certain instruments in the catalogue as "stock buffer of highly liquid assets" will lead to an increase in the demand for this instrument, which, on the one hand, will deepen and widen the markets for these instruments even more and make financing via these instruments easier on the other.

Questions 4 to 6:

The maturity period transformation belongs to the core functions of banking and works mainly and predominantly via the deposit and credit business. Maturity period transformation can be carried out under certain conditions but also via markets and structured products. The liquidity of certain submarkets had been overestimated in the current crisis. Therefore, this maturity period transformation resulted in a high liquidity risk. This is why it seems to be sensible, in particular, where the maturity period transformation is not predominantly refinanced from deposits to limit these via liquidity key figures. A high deposit to loan ratio in the Group consolidates, subconsolidates national and at single institute level appears to be sensible, as it has proven to be a stabilising factor also in the current crisis. In contrast, a maturity period transformation, which assumes always-available liquidity on all submarkets has turned out not to be sustainable and quickly led to solvency problems via liquidity problems.

It seems to be sensible, in particular, where the maturity period transformation is not predominantly refinanced from deposits to limit these via liquidity key figures.

In order to assess the weights, which should have individual passive resp. active positions it seems to be sensible to take a closer look at the chronology and cause analysis of the current crisis. One of the central starting points of the crisis was the originate and distribute model, i.e. the certification of loans in connection with wrongly rated und wrongly priced risks as well as the - obviously - wrong assumption of always-available liquidity on the markets for wrongly rated certified und recertified credit instruments. Some of these submarkets could only revived or survive thanks to unconventional measures taken by the central banks.

In contrast, the originate and hold model has proved to relatively stable in a crisis, among others because the risk in the balance sheet of the own company continues and therefore any risk review is carried out more responsibly. From the point of the AK it is therefore difficult to understand why this proposed weighting of assets should provide incentives for forcing the maturity period transformation by lower weights via instruments, because they proved to be extremely weak in the crisis, whilst for those assets, which have proved to be relatively stable in the crisis, comparably high weights have been provided for. It would therefore be sensible to increase the relatively low weights of the certified instruments relatively to retail credits of the originate and hold type.

Transparency and uniform minimum standards seem to make sense from the point of view of the AK.

Question 7 and 8:

Transparency and uniform minimum standards seem to make sense from the point of view of the AK. Further differentiations appear to be sensible above all with regard to differentiate between deposits covered by deposit insurance systems and those which are not covered by them, as one can assume in case of crisis that deposit covered by deposit insurance systems will prove to be more stable.

Question 9:

In case of a systemic crisis it cannot be assumed that liquidity will be (can be) just be transferred within the Group, it seems to be important that the liquidity provisions at single institute level, at national level, at subconsolidated and consolidated level will be fulfilled.

Question 10 and 11:

A lesson learned from the crisis is that many questions of reregulating the financial sector require a functional approach. To the extent, in which financial institutions assume banking functions, such as the maturity period transformation, they should be subject to the same regulation. On the one hand to prevent regulation arbitrage, which puts pressure on the regulated institutions; and because the crisis has shown that also non-financial institutions, which for example carry out a maturity period transformation via certified instruments and which are not subject to banking regulations, could cause or intensify significant disturbances for the financial sector and the economy as a whole on the other.

If investment companies are able to assume liquidity and maturity period transformation functions, they should - in accordance with the functional approach - be covered by the provisions concerning liquidity (LCR) and Maturity period transformation (NSFR).

Question 13:

From the point of view of the AK, the abolishing of liquidity standards in cross-border branches can only be discussed if the question of reorganising and processing financial institutions has been clarified.

Question 14 and 15:

The development of the monitoring tools should also serve the purpose to interlink micro- und micro prudential supervision better than before.

<u>Section II, Definition of Equity</u>

Questions 17 to 24:

The financial market crisis has clearly shown that the current minimum equity requirements in many cases are not sufficient to guarantee the financial stability of financial institutions and indirectly of the entire sectors.

From the point of view of the AK, the financial market crisis has clearly shown that the current minimum equity requirements in many cases are not sufficient to guarantee the financial stability of financial institutions and indirectly of the entire sectors. The state had to step in and provide missing capital resources to prevent solvency problems. Equity has the function to absorb losses. Minimum equity must ensure that losses, which exceed a normal expected extent, will be absorbed on a going concern basis, thereby preventing the insolvency of an institute. In view of the enormous impact of a bank collapse on the en-

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tire financial sector and subsequently on all other economic sectors, the target of strengthening financial stability must take priority over profitability aspects. Any restrictions of profitability potentials associated with the revision the equity requirements, will probably temporarily lead to short-term yield losses. Also important will be the schedule for the set-up. Too early - before the crisis has been tackled - it could entail the risk that it restricts the lending ability to much. Too late - it might result in a new bubble formation. Overall, higher stability through improved equity resources leads to sustainable positive effects for the economy as a whole. The financial sector too will benefit from measures for better capital resources as they lead to a positive outcome and to sustainable profitability advantages.

In spite of this, it will be important, apart from improving the capital resources, also to consider the procyclicality of regulatory measures. Insofar, the improvement of the capital resources and the cushioning of cyclic effects (dynamic provisioning) are not to be regarded as alternatives, but have to be seen as complementary elements, which will contribute to more stability of the financial sector and the economy as a whole.

It is therefore sensible and necessary to consider the metrics of capital requirements and to examine the quality of the capital itself raising it in future. Until now, the respective national provisions have enabled a broad scope for defining the quality of equity. A standardisation of the definition and a delimitation of equity at European level bring more clarity and transparency and are above all necessary as financial institutions are operating as affiliated institutions across national. Any impact of solvency problems is therefore also "exported" across boundaries.

The new definition of "regulatory capital structure" is welcomed by the AK. Focussing more on the core capital - but also its differentiation - is from our point of view an important step in the right direction. This concerns both the strengthening of tier 1 capital as well as the elimination of tier 3 capital. The proposed elimination of tier 3 capital as well as borrowing with terms of two to five years from the capital structure makes sense as the quality of tier 3 capital is low and can only to a very limited extent be used for covering losses in case of a crisis. Within the scope capital adequacy, tier 3 capital is hardly significant so that the elimination will not have any noteworthy impact.

The differentiation of tier 1 capital in core capital and non-core capital improves the focus on the highest quality grade of equity, whereby nominal capital and reserves are the main components of core capital. Hybrid capital - in its different forms and qualities - is valued accordingly and will not be attributed to the core capital.

If the capital fulfils the criteria, listed in Annex IV, it is acceptable from the point of view of the AK, that also capital of non-joint-stock companies such

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as cooperatives or savings banks are attributed to the core capital. The criteria listed in the Annex, such as sustainability, no terminability, no obligatory dividend payments, no pledging of shares etc are in our opinion well suited to delimit the core capital. Also important would be the requirement that the core capital has to be paid in full. The transparent and separate recognition in the balance sheet of the institute must also be rated positively.

Exceptions concerning the attribution to the core capital are formulated in Annex V. What is significant here is above all the deduction of not yet realized profits - they are, as the crisis has shown completely unsuited to cover losses in times of crisis. On the contrary, the valuation rules of IFRS have led to the fact that due to the fair value evaluation overdimensional losses had to be written off in the balance sheets, which procyclically made the crisis even worse. From the point of view of the AK, however, not only unrealised profits from debt instruments, loans, receivables, equities, own use properties and investment properties should be deducted but all not yet realised profits. Not quite clear is the formulation to deduct unrealised losses also from the core capital. This would contradict the principle of creditor protection. The deduction of own shares would also be sensible from the point of view of the AK.

The AK is of the opinion that the current minimum equity requirements are too low and that they have to be raised.

With regard to non-core tier 1 capital, the main focus of CRD IV must be placed on clear definition and delimitation of the hybrid capital. Hybrid capital is a mixed form of equity and outside capital, of which there a vast number of forms and types in practice. The crisis has shown that in many cases "innovative" hybrid capital is not suited to absorb losses. It is therefore important for the qualification of hybrid capital to which extent it can be used to compensate a loss and to which extent interest payments are coupled with the profit situation of the institute. Other important criteria include the term, possible early call privileges, claims to liquidation proceeds and whether hybrid capital may influence the management. The AK regards the eligibility criteria for non-core tier 1 capital formulated in Annex VI, Item 11 as particularly useful. According to this, the carrying capacity of losses must either be possible by a conversion into nominal capital in combination with a previously defined trigger criterion or alternatively a clear attribution of the losses to the hybrid capital as well as by a subsequent definition of a writing-off mechanism. In order to be qualified as non-core tier 1, no fixed dividend agreements must be concluded.

Whether CRD IV can really achieve an improvement of capital resources with "hard" core capital is, however not only a question of definition and differentiation of the various capital form; what will be decisive is the question what minimum quantities will be required. The AK is of the opinion that the current minimum equity requirements are too low and that they have to be raised. The adjustments, however, should be made gradually

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under consideration of the macroeconomic recover process in a realistic timeframe so that the lending ability of the financial sector during the upturn after the current crisis is not restricted. Minimum limits concerning tier 1 capital should be supplemented by distribution blocks within the scope of anticyclic reserves.

To Section III - Leverage ratio

Questions 25 to 30:

Based on the capital backing of risk assets it is possible to curtail the readiness to take excessive risks; however, to achieve moderate borrowing the formulation of a risk independent ratio, which measures the degree of borrowing, seems to be sensible. The leverage ratio will already reduce the procyclicality of credit growth in the boom phase and subsequently also the procyclicality during reducing the credits in the crisis phase. It also represents a limitation of risks through possible cumulative effects, which result from evaluation approaches and special forms of financing, thereby limiting the risk of too big / interconnected to fail and of too big to be rescued. Decisive, however, is the technical construction of the ratio. The narrower the ratio - the equity - is defined the more precise it will be with respect to the desired effect. The AK therefore prefers a narrow definition of capitals in form of core tier 1 or maximal tier 1. In the opinion of the AK, total capital goes too far, it already contains significantly softer capital components, which show an outside capital-like character.

The extension of the control through authorities has to be welcomed in all sectors of the financial market; hence also in respect of businesses, who carry out their own estimate of the Alpha ratio.

The denominator must be as extensive as possible so that all capital with obligations is included. In particular derivative and off-balance sheet positions must be included to 100 % to register the full extent of borrowing. An idea would be to calculate a kind of net borrowing, where high quality liquid assets could be deducted.

The AK also holds the view that a leverage ratio should be implemented at the level of individual businesses as well as consolidated at sub-group or group level.

Section IV - Counterparty risk

Question 31:

The fundamental approaches for an improved measuring of counterparty credit risks such as the integration of stress periods, the consideration of a worsened credit worthiness etc. are to be welcomed. The relevant rations must be arranged in such a way that they also depict the systemic risk. Apart from the risk for the market participants, the risk for the economy as a whole due to the default of one or more market participants must also be considered.

Question 32:

The extension of the control through authorities has to be welcomed in all sectors of the financial market; hence also in respect of businesses, who carry out their own estimate of the Alpha ratio. The argument that the authorities could establish great differences in the estimates of Alpha makes sense.

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Question 33:

Such a multiplier must basically be welcomed. Apart from that, it should be examined whether it could not also be applied to non-financial institutions, in particular where it is not easy to distinguish whether an establishment is a financial institution or a large company. The aim must be not to permit any loopholes, hence to prevent regulation arbitrage by following a functional approach to the regulation.

Question 35:

Requirements for CCP: in view of systemic risks, CCPs must be able to cope with the default of several participants. The extent of the capital injections must also be appropriately large. CCPs must be supervised by democratically legitimised authorities. The margin between the evaluation for clearing via a CCP in contrast to bilateral clearing - even if it in the first case of the EAD must not always 0 - must be large enough to make the incentive for central clearing obligatory.

It must also be examined who is in charge of operating these CCPs. It has to be ensured that this sector is not controlled by the large derivate dealers. If the CCPs are operated by the large dealers themselves, it could result in problematic information asymmetries in their favour.

Question 36:

In view of their significance, the standards for CCPs must be at as high as possible.

Question 37:

The depiction of the counterparty risk is one thing; vice versa, however, derivatives must be as such that risks can be reliably assessed. Risks, which have not been sufficiently assessed, may not be taken.

Section V - Anticyclic measures

To Section 124 and Questions 38, 39 und 44

From the point of view of the AK, the approach of capital buffers seems to be superior to the approach of "through-the-cycle-provisioning for expected credit losses" as it requires far fewer assumptions. As stated in the preliminary remarks, valuation-dependent approaches, which are model-based and inevitably build on historic data, have the same shortcomings as do evaluation approaches and models, which have decisively contributed to the creation and the seriousness of the crisis. It is therefore sensible to put the capital buffer approaches at the centre of any considerations. Approaches of "through-the-cycle-provisioning for expected credit losses" may in addition provide more stable evaluations.

In particular, however, with regard to the ECF approach, comes the fundamental democratic political question of political responsibility of the standardisers. Whilst the legislative and administrative organs at national and at European level are directly or indirectly democratically legitimised, this question is far more difficult to answer in case of institutions such as the IASB.

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The AK regards the dual approach with regard to capital buffers as sensible.

Question 40:

The AK regards the dual approach with regard to capital buffers as sensible. The criteria for its formation are far less assumption-dependent as the "through-the-cycle-provisioning" approach. The formation is far clearer, more transparent and more comprehensible and by fine-tuning the anticyclic buffer, it is possible to establish a connection with the microprudential supervision.

From our point of view, the buffers fulfil two very different but complementary functions. Whilst the conservation buffer should also ensure that the credit supply remains an important bank function during the downturn, which must not restricted by deleveraging, the anticyclic buffer can above all also prevent an excessive credit growth and slightly reduce the formation of bubbles.

From the point of view of the AK it appears to be important, to also integrate titrated credits and similar instruments, which can be used to draw credits.

From the point of view of the AK it appears to be important, to also integrate titrated credits and similar instruments, which can be used to draw credits; for once to ensure that the regulation does not have a distorted effect on the business structure and to avoid triggering regulation arbitrage on the other.

Question 41:

Above all, those elements should be included, which either will bear risks and/or whose incentive structure has a risk-driven effect, i.e. also capital (tier 1 and 2) distributions and variable executive salaries.

Question 42:

There should be a harmonised framework for regaining the targets in case of infringements as on the one hand the national supervisory bodies are better at estimating a local situation whilst there should be binding guidelines in an Internal Market according to which the supervisory bodies should determine the timing on the other.

Question 43:

An important demand on macroeconomic variables is that they should require the minimum number of assumptions. That is why from our point of view concepts such as the deviation from the potential output are not suitable. Practicable solutions appear to be variables, which were mentioned in the text, such as the ratio credit volume (which, however, should alsoinclude titrated credits and similar instruments, with which credits should be drawn in order not to have a distorted effect on the regulation of the business structure) to Gross Domestic Product and the deviation of the credit growth from the trend.

Section VI - Systemic important financial institutions

From the point of view of the AK, the most important approach concerning the treatment of systemic important financial institutions is that in case of a necessary bailout with public funds, it has to be clear that the focus must be on rescuing the banking functions and not on rescuing the institution. If it has become clear that a rescue of the

banking functions, which are important for the stability of the financial system and for the economy as a whole, is also possible without rescuing the owners, this may impede the moral hazard of the owners, which results in the fact that excessive risks are taken to increase the yield, because they are bailed out by the general public. A special bank insolvency law for systemic important financial institutions, with the aim to rescue the banking functions, without the need to rescue the owners, is in our opinion one of the most important approach points.

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